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SUBJECT: NORTHERN ITALIAN "DISTRETTI" HANGING ON

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¶1. (SBU) Summary: The clusters of small same-sector firms known as "distretti" are the backbone of the Italian -- and particularly northern Italian -- economy. To varying degrees these "distretti" have been suffering from the global economic crisis that has hit their traditional export markets. Though some firms will definitely succumb, there are encouraging signs that many of these clusters are turning to innovation and market diversification to keep competitive.

The media has made much of the perception that banks are starving these firms of credit. We believe the more serious short-term problems are the slow recovery of export markets and government policies that don't encourage investment or innovation. Even in the best case scenario, there will be job losses. However, minimizing these losses will be critical for the longer-term demand-driven recovery of the northern regional economies. End summary.

Distressed "Distretti"

¶2. (U) Despite some optimistic signs from the Italian economy and encouraging noises from policymakers in Rome, the future of many of northern Italy's "distretti" is still unclear. As noted in reftel, these geographical clusters of small, export-oriented firms producing the same or similar product are characteristic of the northern Italian economy, where over 70 percent of the country's 101 largest clusters reside. Nationwide these "distretti" employ at least two million people.

¶3. (U) According to GOI data, and discussions with entrepreneurs, the crisis has hit some clusters harder than others. For instance, in the first half of 2009 exports of clothing and fashion were down 18.5 percent year-on-year in Italy and furniture was off 24 percent. On the other hand, food and wine exports were only off 2.4 percent and high-tech exports were down 7 percent. Bank Intesa Sanpaolo data show that during the first semester of this year 11 of the 101 "distretti" (primarily food and electronics clusters) actually expanded their exports. Despite the generally bad news, the drop in the clusters, exports as a whole was smaller than the overall decline in Italian exports year-on-year. As one academic noted, the "distretti" remain the pillar (and future) of Italy's export strength.

¶4. (SBU) Nonetheless, as the crisis lingers we are hearing that a number of small business owners, viewed as heroes who will fight until the last centesimo, are at the end of their rope. It is only a matter of time before they decide to shut their doors rather than sell out or change their age-old model. Indeed, experts with whom we spoke believe some of the harder hit northern "distretti," such as machine tools, chairs, textiles, and jewelry, might shrink dramatically (though nobody predicts disappearance of a cluster). One senior banker told us he expects about 10 percent of Italy's estimated five million mostly small and medium companies to go belly up.

Markets Key to Stauching Job Losses

¶5. (SBU) These SME closures, combined with the looming end of unemployment insurance for those previously laid off from the

largest firms, will lead to job losses in the short term. Economists are telling us that Italy's unemployment crisis has yet to hit. However, for the "distretti" at least the scope of these losses will depend on factors such as access to credit and the recovery of export markets. Media coverage has focused on the former, highlighting public meetings of small business owners angrily accusing bankers of choking them off. Some GOI policymakers have echoed this criticism. Though bankers admit that it is getting harder for SMEs to meet lending requirements, they assert that new credit is down primarily because demand is down -- no markets, no expansion, no new loans requested. The head of one of Italy's largest banks told the Consul General that borrowers still have 61 billion euro in untapped credit lines at his bank.

16. (SBU) Thus, we believe a more serious challenge to the short-term health of the northern "distretti" is the slow recovery of export markets. The length of the crisis, and the number of ultimate firm closures, will depend in good part on the time it takes for traditional markets (Germany and the EU in particular) to start buying again. Thus far, economists have told us the recovery has been focused more in Asia than Europe and the results have been too modest to spell much relief for the SMEs.

17. (SBU) Though less of a concern for the export-oriented northern SMEs, some businesspeople have also mentioned problems in the domestic market. In particular, we have heard complaints about delays in payments by the government or large corporations. In a time when the smaller firms have no fat to spare, payment terms longer than 60 days are no longer tenable.

Innovation and New Markets for the Long Haul

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18. (SBU) In the longer term, survival of firms and clusters will have more to do with their ability to adapt to the new realities of the global economy. This is similar to 2003 when the "distretti" first faced the challenge of Chinese low-cost competition and innovated their way back to prominence. For now, observers are hopeful that as closures occur a new generation of entrepreneurs will step in to revitalize older "distretti" via mergers and retooling, or start new ones in relatively unexplored territory such as energy/environment and aerospace. Also as in 2003, rejuvenation now will require diversification into new markets -- experts mention China and North Africa. Overall, most believe the traditional flexibility and innovativeness of northern SMEs allow them to respond better to the ongoing poor market conditions than their larger, slower peers.

19. (U) Several regional governments have grasped this and are pushing programs to encourage just these things. For instance, in Lombardy the regional government has launched the "Driade Program," which will provide 23 million euro worth of grants to help seven promising clusters become more competitive and find new overseas markets. The funds will be managed by local chambers of commerce and will be used for aerospace, thermo-electric energy appliances, cosmetics, eco-friendly furniture, eco-friendly car components, arms, and nautical equipment clusters. In Piedmont, the regional authorities have already made available 450 million euro in project grants for about 1,000 green technology firms working in ten research centers across the region. Their key sectors in Piedmont are renewable energy, hydrogen fuel, and recycling.

Comment: Distretti Remain Afloat, But Await Wiser Policy

10. (SBU) The good news is that every few months our contacts push off their predicted day of reckoning for most "distretti." Last spring it was September, then it was the end of 2009, now it's spring 2010. For now the dedication of SME owners to survive, the innovations these firms are making, the small but targeted response of regional authorities, and the stirrings of a recovery in some export markets seem to be enough to keep their collective head above water. Low inflation has also helped. A key domestic factor missing is a GOI policy to encourage the enhanced investment and innovation all agree are necessary. In its absence, one

business consultant noted, some troubled firms in the northeast have been moving over the border to EU neighbors Austria, Slovenia, and even Bulgaria, to take advantage of more favorable investment climates. Regardless of the GOI,s response, jobs will almost certainly be lost in various"distretti." Minimizing these losses in the short and longer terms will be critical for the demand-driven recovery of the northern regional economies.

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